

December 2022

Havant Thicket – Cost Adjustment: Draft Decision

About this document

This document sets out our draft decision on Portsmouth Water Limited's ('Portsmouth Water') cost adjustment mechanism application to adjust allowed totex in the Havant Thicket price control in relation to the Havant Thicket Winter Storage Reservoir ('the Havant Thicket Reservoir'). We welcome views of all stakeholders on our draft decision and we will consider consultation responses before making our final decision in early 2023.

Responding to this consultation

In order to meet our timetable to make a final decision, we ask that comments and representations are sent to Kate Kendall by email at Kate.Kendall@ofwat.gov.uk by close of business on **6 January 2023**

We intend to publish responses to this draft decision document on our website at www.ofwat.gov.uk. Subject to the following, by providing a response to this draft decision you are deemed to consent to its publication.

If you think that any of the information in your response should not be disclosed (for example, because you consider it to be commercially sensitive), an automatic or generalised confidentiality disclaimer will not, of itself, be regarded as sufficient. You should identify specific information and explain in each case why it should not be disclosed [and provide a redacted version of your response], which we will consider when deciding what information to publish. At a minimum, we would expect to publish the name of all organisations that provide a written response, even where there are legitimate reasons why the contents of those written responses remain confidential.

In relation to personal data, you have the right to object to our publication of the personal information that you disclose to us in submitting your response (for example, your name or contact details). If you do not want us to publish specific personal information that would enable you to be identified, our [privacy policy](#) explains the basis on which you can object to its processing and provides further information on how we process personal data.

In addition to our ability to disclose information pursuant to the Water Industry Act 1991, information provided in response to this consultation, including personal data, may be published or disclosed in accordance with legislation on access to information – primarily the Freedom of Information Act 2000 (FoIA), the Environmental Information Regulations 2004 (EIR) and applicable data protection laws.

Please be aware that, under the FoIA and the EIR, there are statutory Codes of Practice which deal, among other things, with obligations of confidence. If we receive a request for disclosure of information which you have asked us not to disclose, we will take full account of

your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances.

Where Portsmouth Water or other interested parties are making representations, they should consider what further evidence may be necessary to submit with their representations as a result of this draft determination. Where the company considers that we have not appropriately considered any points previously raised by it, it should include this within its representations.

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1. Summary

1.1 Portsmouth Water's application

At the 2019 Price Review (PR19), Portsmouth Water requested funding to deliver a new 8,700ML reservoir for the purpose of supporting water transfers to Southern Water Services Limited ('Southern Water'). Under the PR19 final determinations, we set a ten-year price control for Portsmouth Water's Havant Thicket Reservoir with an allowance of £123.6m (in 2017/18 prices). Due to the early stage of development of the project at PR19 and the significant uncertainty around costs, we also provided for a cost adjustment mechanism to enable Portsmouth Water to apply for an amendment to the level of totex included in the Havant Thicket Price Control, to take into account changes in cost as a result of the outcome of the planning and procurement processes for the project. We also committed to a mid-period determination in 2024 (as part of our price review in 2024 (PR24)) to allow the price control to be adjusted for the outcome of the cost adjustment mechanism¹. On 28 October this year, Portsmouth Water submitted a request to amend the level of totex we included in its Havant Thicket Price Control for the period 2020–2030 (we term this the cost adjustment mechanism or CAM).

Southern Water have entered into a bulk supply agreement with Portsmouth Water to pay for the construction and operation of the reservoir. This means that Southern Water's customers are paying for the project, and therefore the allowed revenues for the Havant Thicket Price Control are zero for Portsmouth's customers.

Following planning permission for the project being granted, as well as procuring the contracts for the main reservoir works and infill pipeline, Portsmouth Water's estimate of total project costs has increased to £370.4m (in November 2021 prices). Converting the final determination allowance to November 2021 prices, this is an increase of £235.1m. In 2017/18² prices (the price based used at PR19), we allowed £123.6m compared to total project costs of £338.6m which is an increase of £215.0m.

We have carried out an assessment of Portsmouth Water's application, taking into account: evidence provided to us by the company; Southern Water's views; and benchmarking carried out by our advisors HR Wallingford and Chandler KBS. This has led us to our view of allowable costs, which is lower than Portsmouth Water's view of costs as set out in its application. Based on our analysis, our view of costs is between £334.7m and £340.1m in November 2021 prices (or between £306.0m and £310.9m in 2017/18 prices). This represents between an

¹ The mid-point review will also adjust for other things including tax reconciliation and reconciliation of the cost of new debt indexation. Further information on the scope of the mid-point review can be found in the PR19 Final Determinations: Havant Thicket appendix.

² We use CPIH to convert between 2017/18 prices and November 21 prices. This is different to the approach Portsmouth Water has taken in its application where it has used a mixture of CPIH and BCIS. Our approach is in line with our approach to setting prices where totex allowances are adjusted by CPIH.

8.2% and 9.6% efficiency challenge to Portsmouth Water's application. Our view of costs has been accepted by Portsmouth Water, with the exception of £5.4m of costs. These costs are associated with the existing enabling works contract and future compensation events but there is some uncertainty around them and we expect Portsmouth Water to provide further evidence to substantiate them.

The table below summarises the company's application and our assessment.

Table 1: Our view of costs compared to Portsmouth Water's application

(£m)	Company's application 2017/18 prices	Our assessment 2017/18 prices	Company's application November 21 prices	Our assessment November 21 prices
Project totex	338.6	306.0 – 310.9	370.4	334.7 – 340.1

2. Background

This document explains the context for Portsmouth Water's cost adjustment submission and briefly sets out:

- What we allowed for at PR19;
- How any change will take effect;
- What is in Portsmouth Water's application; and
- Our approach to assessing Portsmouth Water's application

What was allowed for at PR19

The Havant Thicket Reservoir is an 8,700ML reservoir that has been identified by Portsmouth Water and Southern Water as the preferred option to meet Southern Water's supply demand deficit, which has arisen as a result of a sizeable reduction on the amount Southern Water is permitted to abstract from the rivers Test and Itchen. The reservoir is expected to be operational in 2029 and will enable Portsmouth Water to make a bulk transfer of water to Southern Water under the terms of a Bulk Supply Agreement entered into between Portsmouth Water and Southern Water in January 2021.

At PR19, Portsmouth Water requested funding to deliver:

- An 8,700 ML earth bund reservoir
- An infill pipeline from Bedhampton Springs to the reservoir
- Network enhancements to support the increased supply into Portsmouth Water's network

At PR19, we accepted the need for the project and included in Portsmouth Water's final determinations a separate ten-year price control for the project (the Havant Thicket Price Control) and allowed £123.6m totex in 2017/18 prices (or £135.3m in November 2021 prices) to deliver the project. As the project is for the benefit of Southern Water's customers, we assumed all of the costs would be recovered from Southern Water under a Bulk Supply Agreement. This resulted in a zero revenue price control, ensuring Portsmouth Water's customers do not pay for the project. We also included totex cost incentives in the Havant Thicket Price Control, with any cost overruns or savings to be shared 50:50 between Portsmouth Water's shareholders and Southern Water and its customers.

At PR19, the project was in a very early stage of development and there was significant uncertainty around the cost of the project – particularly as this would be the first public water supply reservoir to be built in thirty years. To address this uncertainty, we provided for a bespoke cost adjustment mechanism to enable the totex allowance for the reservoir to be adjusted for the outcome of the planning process and procurement activities, which were expected to be completed in 2022.

How any change will take effect

The outcome of the cost adjustment mechanism will be implemented through a mid-period determination in PR24. While at PR19 we set a ten-year control for the Havant Thicket Price Control, condition B of Portsmouth Water's instrument of appointment ('licence') allows us to make a new determination in relation to the last five years of the ten-year price control, if we choose to. At PR19 we committed to undertake this mid-point determination of the price control in 2024 to take into account the outcome of the cost adjustment mechanism, which in turn will enable the charges in the bulk supply agreement between Portsmouth Water and Southern Water to be adjusted to reflect our view of allowable totex. Although the decision on the cost adjustment mechanism will only be implemented in 2024, providing a decision now will give Portsmouth Water certainty as to the level of totex it has been allowed and can recover through the bulk supply agreement. This will support the financing of the project.

What is in Portsmouth Water's application

Portsmouth Water has requested funding for £370.4m of totex for the period 2020–2030, which is an increase of £235.1m (in November 2021 prices) on what was allowed in final determinations in PR19. This is a very considerable increase in costs. However, Portsmouth Water and Southern Water have both confirmed that the project continues to remain the best value for money solution for the provision of future water resources in Hampshire. In addition, it is recognised that at PR19, the project was at an early stage of development and that there was significant uncertainty about the costs.

The overall increase has been driven by increased costs as a result of planning conditions, the development of the design, higher risk pricing, as well as procurement processes resulting in higher construction costs than previously expected. Portsmouth Water considers the increase in construction costs has largely been driven by external events impacting the construction market including: current macro-economic conditions such as the pandemic and the war in Ukraine impacting inflation; the market appetite for projects; and a changing attitude to how construction companies approach and price risk.

Our approach to assessing Portsmouth Water's application

We have assessed Portsmouth Water's application in accordance with our statutory duties and the strategic policy statement of the [UK Government](#). Our statutory duties³ require us (in summary) to set price controls in the manner we consider is best calculated to:

- further the consumer objective to protect the interests of existing and future consumers, wherever appropriate by promoting effective competition;
- secure that water companies properly carry out their functions;

³ The general statutory duties for most of our work as an economic regulator are set out in section 2 of the Water Industry Act 1991.

- secure that the companies are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions; and
- further the resilience objective to secure the long-term resilience of companies' systems and to secure that they take steps to enable them, in the long term, to meet the need for water supplies and wastewater services.

Subject to those duties, we also have duties to (among other things) promote economy and efficiency and contribute to the achievement of sustainable development.

Our draft decision represents our view of the Portsmouth Water's cost adjustment submission in respect to the scope we set out in our PR19 final determination. Our view is informed by the information available to us at the time. This includes information that is provided to us:

- by the company in its submission;
- by the company in response to any queries we have raised;
- other information we have available from other sources, including for example information provided by our advisors and from other sectors/projects.

The draft decision provides all interested parties, including Portsmouth Water, an opportunity to make representations to us on the information we have used to make our draft decision and on the decision itself.

3. Assessment of Portsmouth Water's costs and other consequential changes

3.1 Totex

Table two, below, provides a breakdown of the total project costs Portsmouth Water has included in its cost adjustment application. As we carried out our review of Portsmouth Water's requested costs in November 2021 prices, all the costs in this section are reported in that price base.

Table 2: Summary of Portsmouth Water's cost adjustment application

(£m, November 21 prices)	Portsmouth Water's view of totex	Draft view of allowed totex	
		Lower end of range	Upper end of range
Construction costs	251.0	233.3	238.7
Non-construction costs*	64.5	52.4	52.4
Portsmouth Water's risk contingency	54.9	49.0	49.0
Total	370.4	334.7	340.1

*The total for Non-construction costs also includes development and project management costs as well as the specific non-construction costs.

Portsmouth Water has based its application on:

- the outturn of the bids received for the main reservoir works and main pipeline works;
- a previous cost estimate undertaken in 2020 for the other construction works plus uplifts based on the outcome of the procurement processes for the main works contracts;
- its current projections for non-construction, development and project management costs together with an allowance for risk; and
- benchmarking advice by Arcadis (a consultancy with engineering, cost and commercial cost expertise) who were jointly procured by Portsmouth Water and Southern Water.

In addition, Southern Water has provided us with their assurance that they are supportive of Portsmouth Water's CAM submission, and the level of costs requested including the inclusion of the tendered costs for the main works contracts.

Our assessment of the application

We have reviewed Portsmouth Water's cost adjustment application, with support from our advisors, HR Wallingford and Chandler KBS, who have reviewed and benchmarked the proposed costs. In carrying out our review, we have taken into account:

- evidence Portsmouth Water has provided to support its application, including any third-party advice it has shared such as the Arcadis benchmarking work;
- benchmarking advice by our own advisors; and
- Southern Water's support for the proposed costs.

Due to the early nature of the cost estimate at PR19 and how the project has evolved since then (for example significant changes to the reference design, and conclusion of certain planning and procurement activities), we have not sought to undertake a line-by-line comparison against Portsmouth Water's PR19 submission.

Following our review and engagement with Portsmouth Water on our challenges, the company has reduced its view of totex to £340.1m. We are, therefore, proposing to increase allowed totex for the price control to between £334.7m and £340.1m. This represents between an 8.2% and 9.6% efficiency challenge to the CAM. We summarise the findings of our review below.

- Main works construction costs have been the subject of a full procurement process in 2021 and there is sufficient evidence to support the tendered costs, though there are several areas where we have raised challenges:
 - Main reservoir contract: tendered costs were considered to be above the benchmarks. The costs are higher than our benchmarks. This may be partly explained by the greater level of risk transfer to the contractor in the contract and that this is the first public water supply reservoir in thirty years and may not be accurately reflected in the benchmarks. Consequently, we have accepted the tendered costs for the main reservoir works contract in full.
 - Main pipeline contract: tendered costs were slightly higher than benchmarking advice obtained by Portsmouth Water. In addition, there is the potential for lower costs through an alternative pipeline route and we consider that customers should receive a greater share of any savings associated with a change in the pipeline route.
 - Client Uplift: Portsmouth Water has included an estimate of £5.4m for additional costs that have been identified as a result of detailed design and/or progression of enabling works which are currently being carried out under a separate contract. The costs cover a range of items and are on top of costs tendered by the preferred bidder for the main reservoir contract. The company has not yet fully substantiated

this "client uplift" and therefore we have not included these costs in the lower end of our allowed totex range.

- Other construction costs yet to be procured were considerably higher than our advisor's benchmarking.
- Non construction costs, including planning related costs and project management costs, were not always well evidenced and in some cases were significantly above our advisor's benchmarks. We also found that Portsmouth Water's submission included costs incurred during AMP6 that were outside of the transitional allowances agreed at PR19.
- Portsmouth Water's proposed level of client risk contingency was also considerably above our advisor's benchmarking, and we have concerns that the company's risk estimate does not appropriately reflect the commercial terms under which Portsmouth Water has procured the main works contracts. We consider that Portsmouth has transferred additional risk to contractors through commercial arrangements, reducing risk to itself which should be reflected through a lower risk estimate. Portsmouth has not provided evidence that it has taken this into account when identifying an appropriate risk contingency.
- Opex: Portsmouth Water's application included £1.8m of opex in their view of non-construction costs. We have challenged these costs as part of our challenge on non-construction costs. Following engagement with Portsmouth Water, we have reclassified the £1.8m of opex to capex as they relate to the delivery and commissioning of the reservoir. This change is shown in table 3 later in this section.

Based on our review of costs and the above challenges we have identified, we consider an efficiency challenge of between 8.2% and 9.6% appropriate – this results in a totex allowance of between £334.7m and £340.1m. We have applied this challenge to the costs of the overall project, ensuring that actual tendered costs are fully funded.

Through engagement with Portsmouth Water, we have agreed the above level of efficiency challenge except in one area of costs – the "client uplift" in relation to the main reservoir works which we have mentioned above. These costs (c.£5.4m) account for the difference in the proposed allowed totex range of £334.7m to £340.1m. Portsmouth Water has not yet fully substantiated these costs and we expect the company to provide further evidence in response to this consultation.

In addition to the level of efficiency challenge, we have also agreed with Portsmouth Water that:

- Customers will receive Portsmouth Water's share of savings under the Main Pipeline Works contract as a result of an alternative pipeline route being pursued. Our efficiency challenge above already includes upfront savings of £1.25m from the

alternative route, and Portsmouth Water's share of actual savings above this level will be wholly for customers' benefit up to a cap of £5m on total savings. Savings over £5m will be subject to the normal totex sharing arrangements.

- Professional Indemnity Insurance costs under the main works construction contracts will be a pass-through cost to customers – this was agreed with Portsmouth Water while the company was still procuring the main works contracts and was to avoid bidders including undue levels of risk pricing for Professional Indemnity Insurance in bids as a result of turbulent conditions in the insurance market.
- Totex allowances will be adjusted for changes in steel, concrete and diesel prices over and above those costs priced in the main reservoir contract. Risk contingencies have been adjusted to reflect the risk (either costs or benefits) transferring back to customers. We will agree the details and the precise mechanism for this ahead of PR24.

The table below summarises our view of costs compared to the company's application and also shows our view of allowed capex and opex over the ten-year price control.

Table 3: Our view of costs compared to Portsmouth Water's application

(£m)	Company's application 2017/18 prices	Our assessment 2017/18 prices	Company's application November 21 prices	Our assessment November 21 prices
Project totex	338.6	306.0 – 310.9	370.4	334.7 – 340.1
Capex	337.0	306.0 – 310.9	368.6	334.7 – 340.1
Opex	1.6	0	1.8	0

The impact of our decision on the cost adjustment will only be accurately modelled at PR24.

Please see appendix A for our view of the allowed totex profile and how it translates into a notional RCV.

3.2 Financing

In relation to the cost adjustment mechanism, Portsmouth Water has provided financial projections for the period to 2030 based on the company's current expected costs and timings for delivering the project. Our assessment of these projections is that additional equity is required to finance the project. We have been engaging separately with Portsmouth Water on this point and any adjustment we make to totex allowances for the project is contingent on Portsmouth Water's shareholders injecting appropriate levels of additional equity. We expect to discuss with Portsmouth Water the extent to which the allowable financing costs should factor in that the company is raising all new debt for the project and

whether a company specific adjustment to the cost of debt could be considered. These discussions will inform our draft and final decisions for PR24.

The final arrangements will be agreed as part of PR24.

4. Conclusions/Next steps

Following our review of Portsmouth Water's cost adjustment application, we have provisionally determined costs in the range £334.7m – £340.1m (in November 2021 prices) and propose increasing their totex allowance for Havant Thicket by between £199.4m and £204.8m (in November 2021 prices) at PR24.

Portsmouth Water accept the upper end of the draft determination (£340.1m) and will seek to provide further evidence to substantiate the £5.4m difference to the lower end of our range during the consultation period.

We will discuss with Portsmouth Water how the cost adjustment is implemented through the mid period review at PR24, together with the financing approach in early 2023.

All stakeholders, including Portsmouth Water, now have the opportunity to comment on our draft decision, before we reach a final decision which we expect to publish in early 2023. We would like to receive representations to this draft determination by close on 6th January 2023.

Appendix 1: Application of cost adjustment at PR24

The table below shows how we propose to apply the cost adjustment at PR24 and calculate the midnight adjustment to the RCV. The table is based on allowed totex of £306.0m (2017/18 prices) which is at the lower end of our range for allowed totex. We have assumed 2.92% for the discount factor which is the wholesale WACC applied to the Havant Thicket price control at PR19. The table also assumes all of the allowed totex is included in the RCV (i.e. there is no Pay as You Go (PAYG) expenditure), which is in line with the approach we have set out in section 3.

Table 4: Calculation of Havant Thicket Price Control RCV midnight adjustment to be applied at PR24

£m (2017/18 CPIH deflated prices)	2020/2021	2021/2022	2022/2023	2023/2024	2024/2025	2025/2026	2026/2027	2027/2028	2028/2029	2029/2030	Total
PR19 Totex	10.1	6.1	7.1	17.6	20.4	30.4	22.2	8.2	1.1	0.3	123.6
PR19 PAYG	-	-	-	-	-	-	-	-	0.3	0.3	0.6
PR19 Capex	10.1	6.1	7.1	17.6	20.4	30.4	22.2	8.2	0.8	-	123.0
Ofwat view of allowed totex	11.3	4.7	43.2	73.5	102.2	42.9	12.3	12.8	2.2	0.9	306.0
Difference	1.1	(1.4)	36.1	55.8	81.8	12.4	(9.8)	4.6	1.4	0.9	182.9
Discount factor	2.92%	2.92%	2.92%	2.92%	2.92%						
Number of years discounting	4.5	3.5	2.5	1.5	0.5						
Discounted difference	1.3	(1.6)	38.8	58.3	83.0						
RCV midnight adjustment - applied on 1 April 2025					179.8						

The table below provides an estimated notional RCV for the period 2020-2025 based on our draft decision. It can be used by Portsmouth Water to support its regulatory reporting.

Table 5: Calculation of notional Havant Thicket Price Control RCV for 2020-2025

£m (2017/18 CPIH deflated prices)	2020/2021	2021/2022	2022/2023	2023/2024	2024/2025
PR19 RCV ⁴	10.1	16.0	22.9	40.2	60.0
CAM Discounted difference (cumulative)	1.3	(0.3)	38.5	96.8	179.8
CAM RCV - notional RCV reflecting CAM totex	11.4	15.8	61.4	137.0	239.8

⁴ Table 5 includes the RCV numbers published in the PR19 Final Determination of the Havant Thicket Price Control. There was a small error made in the calculation of run-off at PR19 which is included in the above RCV numbers and which we have agreed will be corrected for at PR24.

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